No. 14,785

United States Court of Appeals

For the Ninth Circuit

WEYL-ZUCKERMAN & COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

REPLY BRIEF OF PETITIONER.

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1. The Commissioner's statement of the question assumes the validity of his contention as to the issue to be decided in this case.

In stating the question the Commissioner's brief refers to the sale of the gas rights in 1947 by Weyl to Pacific Oil Company. With respect to these rights the Commissioner's brief (p. 2) states "which had no cost basis to" Weyl.

Whether or not the gas rights had a substantial cost basis is the very issue to be decided in this case. If Weyl is correct in its contention that the deed executed by it in June, 1946 was a bona fide transaction, then the cost basis of the gas rights to Weyl was $230,000.

In the Commissioner's statement of the question (br. p. 2) he repeats this assumption in his own favor with

respect to the issue to be decided. The Commissioner says that the gas rights were "supposedly received by" Weyl from McDonald, Ltd., its subsidiary. (br. p. 2.)

This is likewise the case with respect to the "Statement" in the Commissioner's brief (p. 3) where he uses the same language, viz.: "supposedly received" with respect to the mineral rights.

The answer is that if the deed of June, 1946 was a bona fide transaction, it follows that by means of the subsequent dividend in kind from McDonald, Ltd. to Weyl, declared on December 21, 1946, the mineral rights were actually and not "supposedly" received.

2. No question is presented in the case at bar as to the proper interpretation of the provisions of the Internal Revenue Code with respect to determination of the amount of gain.

The Commissioner's brief (pp. 2-3) quotes from Sections 111, 112 and 113 of the Internal Revenue Code asserting that these are the statutes involved in the case. We do not question or criticize the propriety of these quotations. But the issues to be decided do not involve the meaning of the code sections. And we mention the point only for the purpose of rebutting any possible implication that the provisions of the code should have been set forth in our opening brief.

There is no dispute here as to the factors involved in calculating gain in the abstract. The only controversy is whether the deed of Henning Tract from Weyl to McDonald, Ltd. can be ignored as a device to avoid taxes. Hence, the outcome of this case depends on the good faith of the conveyance and not on the meaning of the provi-

sions of the Revenue Code for determination of gain or loss.

3. The Commissioner's brief fails to answer the proposition that as the result of the production by Weyl of evidence, the presumption in favor of the Commissioner disappeared from the case.

The production of evidence by the petitioner eliminated from the case the presumption in favor of the Commissioner's action.

This point was argued at pages 40-44 of the opening brief and authorities cited in support. The Commissioner ignores them.

He cites without comment (br. p. 16) *San Joaquin Brick Co. v. C. I. R.*, 130 Fed. (2d) 220, 225 (C.A. 9th). On reading this case we find that it stands for the same proposition as the later one cited in our opening brief, also decided by this Court (*Hemphill Schools, Inc. v. C. I. R.*, 137 Fed. (2d) 961). The essential portions of the opinion in the *San Joaquin Brick* case are set forth in the appendix to this brief. The case squarely holds that as the result of the production of relevant evidence by the taxpayer, the presumption in favor of the Commissioner disappears.

This point is so well settled that it is unnecessary to discuss other cases cited—likewise without comment—at page 16 of the Commissioner's brief in an effort to convince this Court that the presumption continues to exist.

The Commissioner discusses an additional contention advanced in our opening brief, viz.: that the presumption in favor of the Commissioner is neutralized by the fact

that the Commissioner is charging Weyl with fraud. The Commissioner's brief denies that any charge of fraud is involved. There is no need to labor the point. Even if we accept the Commissioner's assertion, the first ground above noted is adequate to settle the point.

4. The fact that the business purpose of the deed to Henning Tract could have been accomplished without inclusion of the mineral rights cannot support the decision against the bona fides of the deed.

The Tax Court concedes that the deed of Henning Tract from Weyl to McDonald, Ltd., had a business purpose in so far as the surface rights were concerned. This is discussed at page 20 of our opening brief.

But the Tax Court decided that it was unnecessary for Weyl to include the mineral rights in the deed and therefore, as to the mineral rights, the transaction was spurious.

In our opening brief we pointed out that the customary mode of transferring property is by deed conveying the entire fee; that there had never been any differentiation between surface and mineral rights in Henning Tract; that there was no reason why it should occur to Weyl's officers that the property should be divided horizontally; that there is no evidence that the subject ever entered their minds; and that if any thought had been given to the subject, the accounting problems would have been so difficult of solution as to discourage the idea. (Op. br. pp. 20-22.)

The Commissioner's brief merely repeats the Tax Court's theory that the business reasons established at

the trial for the conveyance of Henning Tract "related to the *surface* rights rather than the *mineral* rights in question." (br. pp. 16-17; italics quoted.)

This theory has been answered in our opening brief (Sec. 5, pp. 17-26) and needs no further comment.

The Commissioner's brief—going beyond the theory adopted by the Tax Court—attacks the transfer to McDonald, Ltd. in all of its aspects. The Commissioner asserts (footnote 5, br. p. 18) that "the principal reason and net result of the loan" from the Bank of America was "to give taxpayer effective control over the mineral rights in both tracts."

The answer is that the new financing was needed not only to pay for Holly's share of the mineral rights but also for Holly's other interests.

The Commissioner also questions the necessity of maintaining separation of ownership of mineral rights in the two tracts. This subject is discussed at pages 14-15 of the opening brief. The Commissioner says that we have failed

> . . . to explain just how offset wells would be economically advantageous between tracts which are owned by one economic interest, namely, taxpayer and its wholly owned subsidiary, McDonald. (br. p. 22.)

The answer is that the leases to Standard Oil were separate; that the rights accorded to each lessor as to offset wells were fixed and were not cancelled as the result of the acquisition by one lessor of the capital stock of the other. New wells would obviously increase the production

attributable to both Weyl and McDonald, Ltd. as compared to that of other owners in the field.

5. The Commissioner's brief incorrectly describes the transaction in which Weyl transferred Henning Tract to McDonald, Ltd.

As found by the Tax Court, the transfer of Henning Tract by Weyl to McDonald, Ltd. was accomplished by deed which conveyed the entire fee (T. p. 30). The deed is in evidence (Ex. 10).

By means of two separate instruments the two-thirds of the surface rights in McDonald Tract (then owned by Weyl) were also conveyed to McDonald, Ltd. (T. p. 30).

At the outset of the portion of the Commissioner's brief entitled "Argument" he attempts to distort these transactions. He asserts (br. pp. 12-13):

> On June 27, 1946, taxpayer transferred to its wholly owned subsidiary, McDonald Ltd. all surface rights in the Henning Tract and two-thirds of the surface rights in McDonald Tract, thus giving to the subsidiary all surface rights in both tracts. The transfer also included all mineral rights (which had no cost basis to taxpayer) in the Henning Tract.

This statement seeks to create the impression that the transfer of the surface rights in both tracts was accomplished by a single document and that the conveyance contained additional words of transfer specifically referring to the mineral rights in Henning Tract.

The statement is erroneous and misleading. It is in keeping with the Commissioner's attempt to misconstrue

the ordinary and usual characteristics of a deed—to induce the Court to regard it as having a dual purpose.

This is the fallacy which pervades the entire argument by means of which the Commissioner seeks to attack the good faith of the transaction. The same fallacy also appears in the Commissioner's brief where he purports to summarize Weyl's proprietary interest in the two tracts. There the Commissioner asserts:

> By June 27, 1946, taxpayer owned the mineral rights in both the Henning and McDonald Tracts. It also owned the surface rights in the Henning Tract and two-thirds of the surface rights in the McDonald Tract—the remaining one-third of the surface rights being owned by McDonald. . . . (br. p. 12).

The foregoing language would convey the impression that Weyl's title to the surface rights and mineral rights in Henning Tract was derived from different sources and evidenced by different muniments. Of course, this is not the case. On the other hand, this was the situation with respect to Weyl's interest in the McDonald Tract. The mineral rights in McDonald Tract had been acquired through two distinct transactions. The two-thirds of the surface rights in McDonald Tract had been acquired by Weyl through two other transactions.

Throughout the Commissioner's brief we find a continuous effort to divide Weyl's ownership of Henning Tract into surface and subsurface rights. The Commissioner's obvious purpose is to create an atmosphere which will assist his contention that on June 27, 1946, Weyl's business purpose did not justify the execution of a deed of Henning Tract to McDonald, Ltd. and that to accom-

plish that purpose Weyl should have carved out the mineral rights and retained them.

The same fallacy appears in the Commissioner's frequent assertion that the mineral rights in Henning Tract had "no cost basis" (br. p. 13) or a zero basis (br. p. 14). The concept of a separate cost basis for the mineral rights could only arise when they were separated from the surface rights. Prior to such separation the asset was a single one—the land with all its contents. The cost basis was $338,375 (findings, T. p. 30). This cannot be split up and allocated part to surface and part to mineral rights.

It makes no difference that when Weyl acquired the property no one was aware of the gas content.

When on June 27, 1946, Weyl conveyed Henning Tract to McDonald, Ltd. for $338,375, there was no separate cost basis for the mineral rights. In fact there was no feasible method by which the cost of the mineral rights—as an asset apart from the surface—could be determined. Later in December, 1946, when the separation of surface and mineral rights in Henning Tract occurred for the first time as the result of the deed of the mineral rights, then for the first time it was necessary to determine the value of those rights. This was $230,000 and the transaction was reported on that basis.

6. The Commissioner's brief ignores the proposition that the Tax Court's conclusion is in essence an inference drawn from circumstantial evidence.

The opening brief (section 4, pp. 15-17) pointed out that the facts found by the Tax Court are undisputed; that there is—as the Tax Court admits (Tr. p. 35)—no

direct evidence of an intent to recapture the mineral rights for the purpose of tax avoidance; and that in order to sustain the assessment the Tax Court undertook to draw an inference from circumstantial evidence.

This aspect of the decision is ignored by the Commissioner. His failure to mention it must be regarded as a recognition that the point is unanswerable.

Instead of meeting the issue the Commissioner argues the case as if the Tax Court had made a finding of fact that the conveyance was sham. The Commissioner asserts:

> The question is essentially one of fact and in determining the incidence of taxation with respect to the transaction it is necessary to look through the form and ascertain its substance. Commissioner v. Court Holding Co., 328 U. S. 331; Griffiths v. Commissioner, 308 U. S. 355; Higgins v. Smith, 308 U. S. 473; Gregory v. Helvering, 293 U. S. 465. That being so, the findings and conclusions of the Tax Court herein sustaining the Commissioner's determination should not be disturbed unless "clearly erroneous", due regard being had for the opportunity of the trial court to judge the credibility of witnesses (citing cases). (br. p. 15).

In order to reverse the Tax Court it is not necessary to reject any finding of fact. This has been adequately demonstrated in the opening brief.

As to the Commissioner's statement that the "conclusions" of the Tax Court "should not be disturbed unless clearly erroneous" (supra, br. p. 15), this is not the law.

In *Kuhn v. Princess Lida,* 119 F. 2d 704 (C.C.A. 3rd) the court discusses the rule that a finding of fact cannot

be disturbed on appeal unless clearly erroneous. Then the opinion proceeds:

> The rule does not operate, however, to entrench with like finality the inferences or conclusions drawn by the trial court from its fact findings. And so, while accepting the facts competently found by the trial court as correct, an appellate court remains free to draw the ultimate inferences and *conclusions* which it its opinion, the findings reasonably induce. . . . The sufficiency of the evidence to sustain a trial court's conclusion or finding of an ultimate fact remains appropriate matter for an appellate court's consideration; State Farm Mutual Automobile Insurance Co. v. Bonacci, et al., 8 Cir. 111 F. 2d 412, 415. Where the evidentiary facts are not in conflict or dispute, the conclusions to be drawn therefrom are for the appellate court upon review of the trial court's action. . . . (pp. 705-6.)

In *Sears-Roebuck & Co. v. Johnson,* 219 F. 2d 590 (C.A. 3rd) the question was whether the use by Johnson of a trade-name adopted by Sears-Roebuck & Co. was likely to create confusion in the mind of the public. The District Court held in the negative. On appeal Sears-Roebuck & Co. contended that the evidence clearly warranted the inference of likelihood of confusion. In defense of the judgment Johnson relied on the findings of fact and the "clearly erroneous" rule. The question to be decided was the proper inference to be drawn from the basic facts found by the trial court. Reversing the judgment the court said:

> In considering whether or not the district court erred in finding that no likelihood of confusion existed, this court is not bound (although defendants

> contend otherwise) by Rule 52(a) of the Federal Rules of Civil Procedure, 28 U.S.C. In disturbing a district court's findings of basic facts, this court is guided by the "clearly erroneous" provision of Rule 52(a). But Rule 52(a) is not applicable where, as here, the dispute is not as to the basic facts, but as to what inference (i.e., ultimate fact) should reasonably be derived from the basic facts. This court, by examining the basic facts found by the district court, can determine, as advantageously as the district court can, whether or not an inference of likelihood of confusion is warranted. (Citing cases.) (p. 591.)

Thus, in the Sears-Roebuck case the Court of Appeals drew an inference from the facts found which was contrary to that adopted by the trial court and favorable to the award of relief to plaintiff. In the case at bar all that is necessary is to decide that the findings of fact do not warrant the inference of tax avoidance adopted by the Tax Court.

7. The Commissioner's brief ignores the proposition that under settled principles of law as to inconsistent inferences, the decision that the conveyance was sham is without support.

The rule pertaining to circumstantial evidence and the effect of possible inconsistent inferences was discussed in the opening brief. The pertinent authorities are there cited (section 5, pp. 17-19). All this is ignored by the Commissioner. Surely, the judicial precedents controlling the case at bar are entitled to consideration. Here again the Commissioner's silence is tantamount to the admission that he is unable to answer the point.

8. The Commissioner seeks to defend his assessment on the same ground adopted by the Tax Court—which is based on mere conjecture and suspicion.

As we have seen, there was no duty on the part of Weyl to justify the good faith of a transfer to McDonald, Ltd. of Henning Tract in its entirety as opposed to a transfer of the mineral rights alone. The fact that McDonald, Ltd. needed only the surface rights—which neither the Tax Court nor the Commissioner disputes—does not compel the inference that with respect to Weyl's failure to carve out the mineral rights the deed was the first step in a program of tax evasion.

Hence, the decision of the Tax Court has nothing to support it but suspicion and surmise.

Pertinent to this proposition are such assertions in the Commissioner's brief as that concerning the desirability of consolidating the farming operations of McDonald and Henning Tracts. The Commissioner points to the fact that while Holly Sugar Corporation was equally interested with Weyl in McDonald, Ltd., both tracts had been farmed extensively year after year under separate ownership (br. p. 17).

The answer is that when two contiguous parcels come under single control there are many economies to be accomplished by consolidating the title. The fact that theretofore the two tracts had been separately farmed does not even tend to dispute the advantages flowing from single ownership. Obviously, there is no merit in the Commissioner's assertion that because of the previous separate operation "the alleged farming and operating reasons pale into insignificance" (br. p. 17).

Another excursion into the realm of imagination is the Commissioner's statement (footnote 8, br. p. 21) that "there is some indication that Standard had prepared papers to effect separate conveyances from taxpayer and McDonald". The same subject is mentioned at page 9 of the Commissioner's brief. The Commissioner merely refers by page number in the transcript to a comment in the Tax Court's opinion and the testimony of Schroeder, the Commissioner's witness.

In our opening brief we analyzed Schroeder's testimony on the subject and demonstrated that, despite vigorous cross-examination by the Commissioner's counsel, Schroeder gave no testimony as to the contents of the document which had been initially prepared by the counsel for Standard Oil Co. The Commissioner's assertion as to "indication" in the evidence is unwarranted.

The foregoing comment is also pertinent to the Commissioner's assertion that "viewing the overall transaction, the ultimate sale of the gas rights must have been anticipated by taxpayer's president, Maurice Zuckerman, prior to June 27, 1946," (br. p. 22.) This is a gratuitous assumption; it is not warranted either by the evidence or the findings.

At page 23 of his brief the Commissioner says that as the result of the purchase of Holly Corporation's shares in McDonald, Ltd. the taxpayer "had complete control over both tracts." This is true.

But there is no basis for the conclusion which the Commissioner seeks to draw—that the taxpayer "was in a position to control and handle the possible settlement of

the difficulties with Standard by sale on its own terms." (br. p. 23.) It is obvious that the terms of sale could not be dictated by Weyl. It takes two to make a bargain. If Standard had adhered to its initial offer, there would have been no sale at all.

Another excursion on the part of the Commissioner into the realm of imagination occurs in his assertion that included in the dividend of December, 1946, from McDonald, Ltd. to Weyl were some mineral rights which were not conveyed to Standard Oil and that these retained rights had a value which should have been reported by Weyl. (footnote 3, br. p. 14.) There is no evidence to support the Commissioner's assertion that these additional rights had value. He advanced the same contention in the Tax Court. It was rebutted and the Tax Court apparently was convinced because its opinion does not mention the subject.

The retained rights to which the Commissioner refers were minerals other than gas and also the gas below the eocene-cretaceous contacts. The Engineer Revenue Agent investigated this aspect and reported that these rights had no "particular value." This finding, dated April 18, 1949, is a part of the Revenue Agent's report and is as follows:

> *Value of mineral rights retained*
>
> It is believed that no particular value can be attributed to mineral rights retained.
>
> Weyl-Zuckerman #1 penetrated the Cretaceous for about 2000 feet with no reported showings. The Cretaceous has been producing in only one gas field in

> Northern California and here the record shows the Eocene was missing. It has been concluded that the value of any retained mineral rights is too speculative to warrant the establishment of any particular value.

Furthermore, the subject is immaterial to any issue in the case. It has nothing to do with the business purpose of the conveyance of the Henning Tract made by Weyl to McDonald on June 27, 1946.

The only purpose of the Commissioner in going so far afield is to impugn Weyl's conduct and inspire prejudice.

The ultimate and most far-reaching surmise on the part of the Commissioner is that in June, 1946—when Weyl conveyed Henning Tract to McDonald, Ltd.—this was done in contemplation of a future sale of the mineral rights to Standard Oil Co. In the opening brief (section 6, pp. 26-30) the conditions which prevailed in June, 1946 are set forth in detail. There we demonstrated that the circumstances indicated the unlikelihood of a sale. In the face of this evidence the Commissioner undertakes to present as his concluding argument—echoing the theory of the Tax Court—that "on the evidence as a whole the possible sale to Standard was contemplated from the beginning" (br. pp. 26-27). On the contrary, the evidence demonstrates that there appeared to be no possibility of a sale. Furthermore, the decision as to intent to evade taxes cannot be supported on the mere speculative ground that a sale was within the realm of possibility.

9. The Commissioner criticizes the sale of Henning Tract at cost but fails to answer the reasons advanced in the opening brief justifying this aspect of the transaction.

The opening brief (section 7, pp. 33-36) demonstrates the propriety of the sale at cost and the immateriality of the increase in value which had theretofore been recorded on Weyl's books.

The Commissioner fails to answer this argument. In his brief (pp. 4-5; 23-24) he is content to repeat the comments of the Tax Court which insinuate that the transaction is open to criticism because the sale was made at cost. Finally, the Commissioner says:

> Regardless of what proper accounting and bookkeeping procedure might require in the case of a sale of an asset by a parent to its subsidiary at more than cost, that certainly did not prevent a sale of the Henning Tract mineral rights at their market value. (br. p. 24.)

In the above extract the Commissioner incorrectly states the point presented in the taxpayer's opening brief (pp. 33-36). As to the assertion that nothing prevented a sale at market value, this certainly does not provide any sound reason why the sale should have been made on that basis. It is obvious that merely because it is permissible to pursue a particular course, it does not follow that failure to pursue it constitutes evidence of bad faith.

10. There is no evidence that the dividend of December, 1946, was planned at the time of the conveyance of Henning Tract by Weyl to McDonald, Ltd.

The conclusion of the Tax Court that a round-trip of the Henning Tract rights was planned from the beginning

does not suffice to support the deficiency assessment. There must be evidence that the dividend was contemplated as a part of the original scheme. In our opening brief we pointed out that neither of these conclusions finds any support in the evidence.

The Commissioner's attack on the dividend is not only inadequate to accomplish his objective. Even as far as it goes, it is fallacious.

Concerning the consequences of a direct conveyance by McDonald, Ltd. to Standard Oil the Commissioner argues that "McDonald would have received ample funds with which to meet its obligation" to pay the Bank $50,000 on the principal of the loan. (br. pp. 11-12.) The answer is that all the funds derived from the loan were needed to pay pressing obligations and were used for that purpose.

The Commissioner attacks the dividend as an effort by McDonald, Ltd. to "evade its contractual obligation to the Bank of America." (br. p. 20.) The word "evade" is not justified. All that was accomplished was an essential postponement of maturity of a part of the principal.

The Commissioner says that "McDonald could not profit in the long run by such a maneuver." (br. p. 20.) The answer is that McDonald, Ltd. was seeking not profit but—as we have seen—deferment.

The Commissioner says that by direct sale McDonald, Ltd. "would have received the $230,000 and thus would have had ample funds with which to honestly meet its obligations." (br. p. 20.) Again the answer is that the $50,000 could not be spared. The unwarranted implica-

tion that the course pursued was dishonest does not merit a reply.

The Commissioner's criticism of the protest (br. pp. 20-1) has been anticipated in our opening brief (pp. 29-30, n. 4). No further comment is necessary except to point out that the partial quotation at page 21 of the Commissioner's brief does not accurately reflect the full import of the protest.

The Commissioner cites the *Transport Trad. & Term. Corp.,* case (176 F. 2d 570, 572 (C.A. 2d)) contending that it supports the conclusion that the dividend by McDonald, Ltd. "can only be considered as a distribution to escape a tax." (br. p. 25.) The *Transport* decision is adequately explained in our opening brief (p. 38). There was no business reason for the dividend in that case.

Finally, the Commissioner's brief quotes from *C.I.R. v. Court Holding Co.,* 324 U.S. 331, 334, a statement that a "transaction must be viewed as a whole . . . from the commencement of negotiations to the consummation of the sale." In that case the negotiations were continuous up to the point of consummation; in the case at bar the negotiations were broken off and the subject of sale was abandoned until later reopened. Furthermore, the rationale of the *Court Holding Co.* case cannot accurately be appraised without considering *U. S. v. Cumberland Co.,* 338 U.S. 451, 94 L. Ed. 251, where the opposite result was reached on the basis of facts which were somewhat similar. The Court held that those in control of a corporation can select a roundabout course for disposing of a corporate asset and maintain the

integrity of the transaction even though the choice is dictated solely by an intent to escape taxation and without any business necessity.

Dated, San Francisco, California,
February 23, 1956.

Respectfully submitted,
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(Appendix Follows.)

Appendix.

Appendix

San Joaquin Brick Co. v. Commissioner of Int. Rev., 130 F. 2d 220 (C.C.A. 9th) (1942)

". . . (T)he argument of both parties to this appeal on the question of the conclusiveness of the Board's finding discloses a misunderstanding of the expressions often made by the Courts that the Commissioner's determination is supported by a presumption of correctness and that the taxpayer has the burden of showing it to be wrong. See, for instance, *Welch v. Helvering*, 290 U.S. 111, 115, 54 S.Ct. 8, 78 L.Ed. 212.

In *Perry v. Commissioner*, 9 Cir., 120 F. 2d 123, 124, this Court undertook to explain such expressions by saying, 'This finding (the determination of the Commissioner) is presumptively correct, that is, until the taxpayer proceeds with competent and relevant evidence to support his position, the determination of the Commissioner stands. When such evidence has been adduced the issue depends wholly upon the evidence so adduced and the evidence to be adduced by the Commissioner. The Commissioner cannot rely upon his determination as evidence of its correctness either directly or as affecting the burden of proof.' "